

Section 25114 is amended to read:

§ 25114. Presumptions Arising from Federal Audits.

(a) Examinations.

(1) In general. The Franchise Tax Board shall ~~conduct an examination of~~examine the tax returns of any taxpayer which hasall taxpayers that have made an election pursuant to Revenue and Taxation Code section 25110. In those cases in which such ~~examination review or inspection~~ reveals that there may be potential noncompliance with arm's-length standards involving the transfer of goods, services or intangibles, or the lending of money between those entities whose income and apportionment factors are required to be considered pursuant to Revenue and Taxation Code section 25110 and other affiliated corporations, an detailed audit examination of such transactions ~~shall~~may be conducted unless the taxpayer has been, or is currently, under examination by the Internal Revenue Service with respect to the same year on the same issue. ~~A detailed audit shall be conducted regardless of the fact that there may be no potential tax change or that the potential adjustment to tax shall be less than the cost of the audit.~~

(2) Principles under which a transfer pricing examination is to be conducted. ~~Examinations required pursuant to Revenue and Taxation Code section 25114 shall be carried out pursuant to~~The Franchise Tax Board shall use the principles and procedures followed by the Internal Revenue Service in conducting examinations under Internal Revenue Code section 482 to prevent the evasion of taxes or to clearly reflect the income of two or more organizations, trades, or businesses.

(b) Presumptions regarding ~~audits~~examinations by the Internal Revenue Service.

(1) ~~Audits~~Examinations. With respect to those taxpayers which have been subject to an detailed audit examination by the Internal Revenue Service involving the application of Internal Revenue Code section 482, it shall be presumed that:

(A) if a final adjustment was made under the authority of Internal Revenue Code section 482 ~~or Subchapter N of Chapter 1 of Subtitle A of the Internal Revenue Code~~, it is correct and that no further adjustment is required for the issue or transaction adjusted,

(B) if no adjustments have been made or proposed under the authority of Internal Revenue Code section 482, none are necessary.

(2) Overcoming presumption. The presumptions set forth in paragraph (1) may be overcome by either the Franchise Tax Board or the taxpayer by a showing that:

(A) an adjustment or a failure to make an adjustment was erroneous,

(B) the result of any possible adjustment would produce a minimal federal tax change because of correlative or offsetting adjustments, including the operation of net operating losses, the federal foreign tax credit or the shifting of income or deductions between years, or

(C) substantially the same result was obtained under other sections of the Internal Revenue Code.

EXAMPLE:

T, a U.S. incorporated entity, has had operating losses of \$1,000,000 for each of the five preceding years, 1-5, giving rise to a \$5,000,000 net operating loss carry forward. In year 6, a possible pricing adjustment was considered between T and its foreign subsidiary F. The adjustment would increase T's income by \$1,000,000. For years 7, 8 and 9 T has operating losses of \$500,000 a year. There are no pricing adjustments between T and F which could affect their federal income tax liability for such years. The Internal Revenue Service makes no adjustment with regard to year 6. There is no presumption attached to the failure to make an adjustment because no federal revenue change would occur.

(3) Lack of ~~audit~~examination. No presumption of correctness arises with respect to any transaction which has not been subject to an ~~an detailed audit examination~~ by the Internal Revenue Service pursuant to Internal Revenue Code section 482.

(4) ~~Detailed audit~~Internal Revenue Service examination. For purposes of this section, a ~~detailed audit transfer pricing examination~~ of a transaction or issue by the Internal Revenue Service requires a referral to an International Examiner and his/her direct participation in the ~~audit examination~~ of the taxpayer as documented by notice that the examination was being conducted pursuant to Internal Revenue Code section 482 with respect to such transaction or issue.

(c) Use of federal regulations. Effective as of January 1, 1988, in making distributions, apportionments, and allocations pursuant to Revenue and Taxation Code section 25114, the Franchise Tax Board shall follow the rules, regulations and procedures of the Internal Revenue Service in conducting ~~audits examinations~~ under Internal Revenue Code section 482 as described in the regulations to such section applicable to the taxable year being ~~audited~~examined.

(d) Definitions. For purposes of this section, the following definitions are applicable:

(1) Examine. To examine is to review or inspect a tax return, which may or may not include an audit of the return.

(2) Examination. An examination is an audit of a tax return including a desk audit as well as a field audit.

(e) The amendments made to this regulation shall apply to examinations commenced by the Franchise Tax Board on or after January 1, 2008. An examination will be considered commenced when a taxpayer is first contacted by the Franchise Tax Board concerning any examination with respect to the taxpayer's return.

Note: Authority cited: Section 19503, Revenue and Taxation Code.

Reference: Section 25114, Revenue and Taxation Code.